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Financial Transformation in the European Union

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The introduction of the euro has attracted a great deal of scholarly attention. Meanwhile, the transformation of financial regulations and institutions in Europe has been largely neglected. Yet harmonized rules, mutual recognition of foreign national laws, new regulation-making procedures, and coordinated implementation and supervision could have a more fundamental impact on European societies and the global political economy than the single currency. This regional development is exceptional even for the world of international finance, where markets and regulatory regimes have been in constant flux since the breakdown of the Bretton Woods system. Around the globe, changes in EU financial arrangements are creating new expectations among transnational firms and enhancing the positions of European national and EU officials in international forums (Posner 2005*a*). Inside Europe, the financial transformation is propelling the region toward a single financial market. It is likely to generate far-reaching economic, social, and political repercussions by accelerating the posteuro improvement in the ability of households, companies, and governments to access capital at rates and in amounts comparable to the USA. Large and small companies, as well as the owners and managers of mobile capital, are already able to meet their financing and investment needs in Europe to a much greater extent than in the past when New York was frequently the only option (Burgess and Postelnicu 2005; Authers and Gangahar 2006; Blackwell 2006; Wighton 2006).

The sudden acceleration of EU financial integration is a puzzling turn after years of seemingly modest progress and disagreement. Financial markets are institutions that are highly resistant to change, reflect accepted political bargains and often seem like a natural part of social life (Zysman 1983; McNamara 1998; Fligstein 2001; Posner 2005*b*; Jabko 2006). In the era following the SEA, finance emerged as among the most sensitive areas, and intergovernmental cooperation

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lagged behind other sectors. Then, in the late 1990s and early 2000s, a broad consensus to leap ahead with financial integration crystallized. This chapter examines and explains this empirical pattern of abrupt change.

EU financial transformation also poses theoretical challenges for scholars interested in how history contributes to understanding institutional change. There is a strong tendency to attribute abrupt change to abrupt causes such as exogenous shocks (Pierson 2004: 96–102). In the case of the end-of-the-millennium transformation in Europe, the temptation is to look for explanations in the euro's introduction or the American economic challenge. Recent research, however, drawing attention to 'slow moving' causal processes (Pierson 2004; Thelen 2004; Posner 2005*b*) prompts the central theoretical questions of this chapter: to what extent and by what mechanisms are small integrationist actions that cumulate over time responsible for the EU's financial transformation? In more general terms, can incremental processes cause sudden bursts of change?

This chapter thus addresses core themes of the volume. In particular, it explores the impact of path dependence and shocks on an important EU outcome (see the editors' introduction to this volume). My findings offer an interesting twist to HI efforts to explain institutional innovation. They suggest that path-dependent (i.e. self-reinforcing) processes are more complex than commonly portrayed. Small incremental changes may generate a parallel process: they accumulate over time in ways that make existing arrangements vulnerable to policy entrepreneurs when a potentially transformative exogenous event occurs. In EU finance, powerful interests vested in the status quo ensured for decades that financial change would proceed slowly and in small stages. But the formidable obstacles to change did not lock institutional arrangements in place. Instead, a buildup of seemingly unremarkable actions produced conditions that by the late 1990s made EU finance ripe for rapid change. For certain, the euro's advent and the rise in US competitiveness are important. However, their impact was contingent on a quarter-century of actions, largely by Brussels civil servants but also by governments, transnational firms and other interested parties. In the remaining sections, I demonstrate that any explanation that does not take these slow-moving cumulative effects into account will be inadequate.

EU Financial Transformation: A Puzzle

What is an integrated or single financial market and what do I mean when I refer to recent developments as a financial transformation? An integrated financial market would allow capital and financial services (such as those provided by banks, brokerage houses, stock exchanges, asset managers, and insurance companies) to flow freely throughout the region. Advocates of increased integration argue that the absence of a single large financial market has had profound economic

effects (Lamfalussy 2001: 9–10). On the micro side, they point to the higher costs of financing because of an inefficient match between the supply of capital from savings and its demand from businesses and to limited and poor consumer choices of investment and pension funds, mortgages, and insurance policies. On the macro side, they highlight the losses to potential gains in productivity, economic growth, and job creation. Detractors of financial integration are concerned about the effects on domestic financial services industries (especially the centralization of financial activity in London), the autonomy of national governments to carry out an independent economic agenda, and the welfare state's ability to act as a buffer against the extremes and risks that accompany financing via capital markets.

I use financial transformation to refer to recent substantive and procedural reforms that have moved the EU significantly closer to an integrated financial market. Even though the development of such a market was among the earliest EU aims, strongly reinforced in the single market program, until the late 1990s progress had been modest. An agreement to liberalize capital accounts (Council Directive 88/361/EEC) proved only an initial step, and a series of directives, applying the principle of mutual recognition to banking, insurance, and investment services, was generally too weak to overcome differences in national regulations, legal systems, and cultures. In addition, the financial integration project was plagued by inconsistent implementation of regional legislation as well as old-fashioned national protectionism (Story and Walter 1997: 314–15).

The European Council's March 2000 endorsement of the Financial Services Action Plan or FSAP, a list of forty-two proposed EU laws aimed to remove the above-mentioned obstacles, marks a turning point (Commission 1999). In contrast to other parts of the Lisbon agenda, EU policymakers met the original timetable set by the European Commission for adopting 98 percent of the new legislation and have now entered the consolidation stage focused on consistent implementation and enforcement and correcting poorly performing legislation (Dombey 2004; FT 2004; Commission 2006*c*). This outbreak of legal activity contrasts sharply with the post-SEA legislative processes in two ways.

First, the recent acceleration of legal integration differs both in its magnitude (i.e. the number of new laws and the breadth of issues addressed) and quality (i.e. the degree to which EU legislators employed the principles of harmonization and convergence). Second, unlike the earlier period, it was accompanied by an agreement, known as the Lamfalussy Process, that alters financial rule-making procedures and bolsters coordination mechanisms for transposition, implementation, and enforcement (Lamfalussy 2001; Bergström et al. 2004; Alford forthcoming; Quaglia forthcoming). The Lamfalussy Process introduced two innovations in the formal legislative procedures. It distinguished between broad framework legislation produced through normal codecision procedures and detailed rules created through committees of experts, national regulators, and European Commission officials (i.e. through a comitology procedure); and it introduced a more

transparent process involving public hearings and opportunities for outside commentary. The Lamfalussy Process also spawned an elaborate informal network of new and reformed committees that links national finance ministries and supervisors, the European Commission, the EP, and private sector experts. As a whole, these changes contrast sharply with decades of slow, intermittent and uneven change and ineffectual agreements. They amount to a giant shift of financial regulation from the national to the supranational level and put in place many of the institutional and political foundations necessary for integrated financial markets.

The transformation in finance is particularly surprising because of the remarkable degree of consensus and willingness to compromise among European policymakers in an area traditionally plagued by sovereignty concerns. In the words of a European Commission official, 'No one wanted to be seen to be blocking it'.[2] The financial revolution is all the more mysterious because it began and picked up momentum at a moment when other major EU projects were faltering. In fact, finance, at the time of writing—when member governments seem to be losing their appetite for future enlargements as well as challenging core EU principles—may very well be the site where the integration project is proceeding most intensively.

Existing Explanations for Financial Reform

For the most part, scholars analyzing finance did not interpret European-level developments as important enough to merit investigation. Empirical and theoretical work instead centered on the degree to which global factors or previous national financial arrangements shaped *domestic* institutional change (see Moran 1991; Vogel 1996; Deeg 1999). An important exception is Jonathan Story and Ingo Walter, who maintained in *Political Economy of Financial Integration in Europe* (1997) that the post-SEA Europe-wide laws created a European Financial Area, producing some overall, albeit modest, benefits.[3] They argued that finance lagged behind other parts of the single market program because governments considered it an extension of national sovereignty. Government preferences derived from distinct and largely incompatible financial systems, creating what Story and Walter call a 'battle of the systems'. They thus put forth a two-stage model for accounting for EU financial developments that included a HI derivation of national preferences and an intergovernmentalist bargaining analysis of outcomes. Writing in 1997, they predicted national regimes would 'continue to evolve within their own logic' in the face of global forces and were skeptical of the view that

[2] Author's interview with European Commission official with DG Internal Market in Brussels (June 9, 2004).

[3] Jabko (2006), a welcome addition to the EU focused approach, was released too late to be engaged directly in this chapter. Underhill (1997) and Moloney (2002) are also important contributions.

a future EMU would swiftly bring about benefits and sweep away major national conflicts over the design of a future EU financial system (Story and Walter 1997: 314–15). Their analysis explains well the general resistance to and slow pace of change until the mid-1990s. However, by placing emphasis on national regimes, it fails to capture the potential for transformation inherent in the integration process itself.

Story and Walter were not alone in expecting continued nationally based fragmentation in the euro's aftermath. The projections of most academic and policy-oriented economists who specifically considered EMU's potential effects on financial integration mirrored some of Story and Walter's conclusions: rapid integration of some wholesale markets (e.g. government bonds and the interbank market) but continued fragmentation of a host of others as well as all retail markets (e.g. banking and brokerage services and insurance products) (Gros 1998; Dermine and Hillion 1999).

One difference, however, is that most of these authors maintained an underlying theme of automaticity, whereby a single currency would eventually lead to an integrated financial market (Gros 1998; Dermine 1999). In this sense, several analysts implicitly assumed that the euro's introduction would produce wide-ranging effects, including regulatory reform necessary for intensified market integration. Yet nowhere does one find in this work theoretically derived mechanisms or conditions for explaining why, when and how the elimination of currency risk and transaction costs might shift policymakers' preferences toward the kind of consensus necessary for transformational regulatory change.[4] In fact, recent research, showing that EU countries both inside and outside the euro-zone are experiencing similar EMU effects, raises serious doubts about the direct causal linkages between the single currency, financial markets, and regulatory systems (Askari and Chatterjee 2005).[5] Thus, the research investigating the euro's impact leaves us without an account for why, when, and how EMU might prompt decision-makers and firms to alter their positions toward financial integration.

Gradual Causes, Abrupt Change

Even though the new currency's introduction has received most of the attention, it was not the only major event that may have had an impact on the EU's financial transformation. International developments, especially the acceleration of US economic growth in the late 1990s, were also important. The challenge,

[4] For a compelling discussion of the relationship between monetary union and political development, see McNamara (2003).

[5] Even a cursory understanding of the US experience, where postdepression laws ensured fragmentation of a range of financial markets along state lines for decades, might have raised these doubts.

then, is to understand in what sense and to what extent such external events cause institutional change and, specifically, preference convergence in turn-of-the-millennium Europe.

One way scholars have begun to tackle such problems is to think about causes and effects in temporal terms (Büthe 2002; Pierson 2004; Thelen 2004). In the most prevalent approach, researchers envision institutional change in terms of sudden causes and abrupt leaps forward (Pierson 2004: 96–102). The shock-and-shift approach lends itself to parsimonious models because one can assume a static institutional context and fixed interests, capabilities and authorities without stretching the imagination. If the lion's share of institutional change occurs at discrete moments in time, then small reforms taking place in between critical junctures can be ignored for the sake of theorizing. For students of the EU, the underlying causal story is a familiar one. Actors with fixed interests shift policy preferences in reaction to stimuli—whether these derive from the international system or previous acts of EU integration. Actors interpret such changes in the external environment with little difficulty, know what they want and adjust their policy preferences unproblematically and quickly. European Commission officials, for example, would be expected to take advantage of the euro's advent by leading a crusade to reap the benefits of the currency through a dramatic advancement in financial regulatory integration.[6] Finally, the shock approach is well suited for generating falsifiable hypotheses. If it accounts for the EU's financial transformation, we should find evidence showing a correlation between the timing of preference change and political action, on the one hand, and the stimuli, on the other.

My skepticism towards such an explanation for financial transformation is not rooted in doubts about finding supportive evidence. As I show below, substantial evidence ties the timing of the euro and the US economic rise to EU institutional change. In particular, the empirical record demonstrates that the European Commission and some finance ministries of large member states, especially France (though also multinational firms to a lesser extent), responded to the new currency and the US challenge, generated broad support and otherwise led the process of change. My concern is that this type of analysis mistakes catalyst for cause.[7]

The problem lies not in what the shock-as-cause models contain, but in what is missing. The gradual thickening of the EU polity, the process preceding the shocks, is excluded as a plausible causal force. This makes little sense. To a significant extent, landmark institutional change must by necessity be the result

[6] Arguing that the European Commission acts as a policy entrepreneur, taking advantage of political opportunity structures, is standard across multiple approaches to European integration. See Sandholtz and Zysman (1989), Garrett and Weingast (1993), Fligstein and Mara-Drita (1996), see also Büthe (in this volume).

[7] This phrase is a modification of Jonah Levi's (1999: 55).

of incremental processes, and any persuasive explanation will weigh the impact of these background processes against the effects of shocks and investigate their interaction. The logic here is based on the complexity of major institutional change. Consider what the EU financial transformation entails. Below the surface of new legislation and procedures lies a foundation of necessary building blocks. An incomplete list includes, first, a general set of ideas for interpreting problems and developing solutions; second, a practical program of specific legislative measures; third, a frame that resonates broadly among firms, governments, national and supranational officials, and the EP; and finally, a supportive coalition of actors. Creating any one of the four would have posed formidable challenges. None could easily have been constructed from scratch in the six years between the FSAP proposal and completion. At least some of them were products of the past, of small steps that went largely unnoticed.

Thus, a second type of temporal analysis, focusing on the development of conditions over time that enable shocks to hasten history, is necessary for understanding major episodes of change. Such an approach pushes historical institutionalism in new directions. In the classic version, as Meunier and McNamara highlight in the opening chapter of this volume, a major theme is that existing arrangements often generate increasing returns to empowered interests, who then seek to maintain the status quo. This insight allows scholars to develop powerful logics for understanding slow-moving causes and effects, but fails to provide tools for generating a priori arguments to explain sudden episodes of institutional innovation. By building on an overlooked aspect of such path-dependent arguments, my approach contributes to efforts to overcome this shortcoming (Pierson 2004).

The key point is that mechanisms that reinforce the status quo rarely lock existing arrangements in place. They slow the pace of change by ensuring that it occurs in increments but do not typically halt its progression altogether. What then happens to these by-products of path-dependent processes? What is the effect of these incremental changes over time? I argue that their accumulation lays conditions that make existing arrangements vulnerable to sudden events. Absent external shocks, slow-moving cumulative causal processes are unlikely to produce rapid transformation and are less deterministic than other slow-moving processes, such as those following threshold or causal chain logics (Pierson 2004: 82–90).[8] Yet the relationship between cumulative effects and shocks is clear: the latter serve more as catalysts than causes.

In the EU, as in all polities, multiple actors contribute to forging such conditions. Companies, government officials, supranational civil servants and judges, and other interested parties fill the workday with small acts that contribute to

[8] Note that my conceptualization of threshold effects differs slightly from Pierson's. See Pierson (2004: 82–7).

the construction of the regional polity.[9] They support or produce studies, reports, conferences, legal interpretations and proposals, all of which in turn generate discourses and frames, political contests and debates, new networks and actors, and rules that add to the fabric of the regional project. Over many years actions like these add up, producing cumulative effects. At any given moment in time, opportunistic policy entrepreneurs may draw on these preformed coalitions, studies, and political frames to advance their agendas. Gradualist actions thus refashion the political landscape in ways that contribute to incremental institutional change and simultaneously create the conditions for external stimuli to produce rapid transformation.

The emphasis on the accumulated impact of incremental interventions takes us quite far from shock-and-shift approaches that merely stress opportunistic behavior during externally induced crises and helps us understand why some shocks generate immediate and transformational change while others do not. If such an approach is useful for explaining the EU's financial transformation, we would find that *before* the euro's advent and the late 1990s US economic acceleration, interested parties would have already: (*a*) developed general ideas about how a single financial market could be achieved and what problems it would solve (Fligstein and Mara-Drita 1996; McNamara 1998); (*b*) interpreted a need for specific pieces of legislation that could be included in a broad list of financial integration initiatives; (*c*) experimented with effective frames to harness support for financial integration (Posner 2005*b*; Jabko 2006); and (*d*) constructed new political voices and networks of financial sector firms and other nongovernmental bodies inclined toward financial integration (Heritier 2001; Mazey and Richardson 2001; Posner 2005*b*).

Weighing the Effects of Causes with Different Tempos

This section uses three particular outcomes to illustrate the balance and interaction between shocks and background processes in producing sudden institutional innovation.[10] The first and longest example is the emergence of *general* support for a single EU financial market, which coalesced around the FSAP. Observers of past EU efforts to integrate finance might easily have dismissed the Council's March 2000 endorsement of the FSAP as little more than lip service, if this consensus for dramatic change had not also yielded dozens of laws and a new set of procedures for expediting decision-making and improving transposition,

[9] These ideas build on recent research about bureaucratization and bureaucratic action. See Fligstein (1997), Carpenter (2001), Heritier (2001), Mazy and Richardson (2001), Barnett and Finnemore (2004) and Posner (2005*b*).

[10] I build a historical record from interviews with participants, official documents, the financial press, and secondary sources by other scholars.

implementation, and enforcement. Thus, the second case is the passage of a major piece of legislation, the regulation mandating convergence of national accounting standards, which exemplifies how the general consensus translated into specific laws. The third is the adoption of the Lamfalussy procedural reforms.

Building a Consensus for Change: Twin Shocks and the FSAP

How much of the *general* support for regulatory change can be attributed to major events taking place in the late 1990s and how much to cumulative effects of incremental actions? What outcomes did the confluence of the two produce?

The timing of the euro's 1999 introduction and America's end-of-century economic acceleration certainly suggests that there was a link between these 'shocks' and the consensus that emerged in favor of the FSAP. The European Commission's leaders, notably Commissioner Mario Monti, and finance ministers recognized that the euro's introduction and the US challenge presented a unique opportunity for advancing financial integration. The new currency made possible an argument that opportunistic Brussels officials, firms, and governments correctly perceived would resonate broadly and could not be countered easily:[11] the US economy was catapulting ahead of Europe's, and the EU could not reap the full benefits of the single currency until the obstacles to an integrated financial market were removed.[12] This framing quickly became a focal point for rallying support. No one wanted to be seen as opposing financial reform.

Of course, other factors also contributed to the timing of the new consensus. The expansion of domestic capital markets in the late 1990s, for example, imbued both Frankfurt and Paris with a considerable degree of hubris about their prospects for competing with London as the future seat of EU finance. The French Trèsor adopted an offensive strategy, believing that the exportation of French-like regulations would support Paris's role as a future financial center (Lalone 2005). The arrival to the UK Treasury of Gordon Brown in May 1997, moreover, reinvigorated financial reform at home and brought new zeal to the sometimes lukewarm British support for EU financial integration.[13] Brown is not the first Chancellor of the Exchequer to see advantage in a single European market (SEM)—at least in principle. In the late 1990s, however, he found eager French and German counterparts, who having agreed to the new currency could not easily counter a legislative program claiming to deliver the euro's benefits. In addition, Brown had allies in the EP, such as Chris Huhne and Theresa Villiers,

[11] Author's interviews with Delegation of the European Commission official in Washington, DC (May 4, 2004) and European Parliament official with the Committee on Economic and Monetary Affairs in Brussels (June 8, 2004).

[12] One of the earliest articulations can be found in Commission (1998*a*: 5).

[13] Author's interview with former UK Treasury official in Washington, DC (November 4, 2005).

who could fight effectively for City interests while being part of a surprisingly broad profinancial integration coalition that included social democratic Chair of the Committee of Economic and Monetary Affairs, Christa Randzio-Plath.[14]

Finally, financial services firms across the various subsectors, while not initiators of the reinvigorated financial integration project,[15] were easily won over by the Commission's logic. They had watched American financial services companies benefit from a giant home market, develop pan-European businesses and rise to the top of the financial league tables in Europe. Without enhanced integration, the major US banks were likely to be the biggest beneficiaries of the new currency. Not only did the initiative for renewed financial integration prompt existing business lobbies to develop policy positions, it also prompted the creation of new pan-European political voices. The European Financial Services Round Table, composed of the leaders of Europe's major banks and insurance companies, was formed in 2001 and began to produce research and publish their positions in 2002.[16] Eurofi, representing Continental Europe's retail-oriented financial services companies, was launched in 2000 with the stated goal of creating a single capital market in Europe.

Building a Consensus for Change: Cumulative Effects and the FSAP

The above section shows that there is substantial evidence tying major events of the late 1990s to the general consensus for financial change. But persuasive explanations of institutional change must weigh the effects of exogenous shocks against the impact of preexisting conditions and clearly specify how one is related to the other. Were there background conditions, built gradually over time, that were necessary for preference convergence to occur? The following five pieces of evidence suggest there were.

First, the successful framing of the problem and solution was in large part a product of trial-and-error. Brussels officials, in particular, had been experimenting with arguments for selling financial integration since the late 1970s (Posner 2005*b*; Jabko 2006). By giving a euro twist to slogans about job creation and international competitiveness used only six months before the FSAP proposal (Commission 1998*b*), Brussels officials were adding to a gradual evolution of frame experimentation.

Second, the European Commission parlayed a renewed interest in integration among finance and treasury ministers into a massive legislative program. This maneuver required political skills and expertise of how the EU polity works. Neither was instantaneously produced in the EMU's aftermath. The impetus for

[14] Huhne's writings on the subject are available at http://chrishuhne.org.uk/.

[15] Others also find that firms often react to, rather than lead, reform in the EU. E.g., see McNamara (1998: 43–71).

[16] See www.efr.be/index.asp.

the FSAP came from a modest European Council invitation 'to table a framework for action . . . to improve the single market in financial services, in particular examining the effectiveness of implementation of current legislation and identifying weaknesses which may require amending legislation' (European Council 1998: 9). It is not at all clear that the ministers, individually or as a group, envisioned their invitation resulting in a regulatory overhaul. Officials inside DG Market downplayed the ambition of their program, arguing that passage and implementation of nearly four dozen pieces of legislation would 'not require radical surgery' (Commission 1998*a*: 2). They also went to great lengths to make it seem as though the member governments and firms were always in the lead and to appear to be fulfilling a mandate. They achieved this, in part, through a leadership committee, the Financial Services Policy Group (FSPG), whose creation they recommended (Commission 1998*a*: 3). Mario Monti and his successors, Fritz Bolkestein and Charlie McCreevy, later used the committee's chairpersonship to push their agendas.[17]

Third, member government preferences were not merely products of a new framing campaign or other factors related to the events of the late 1990s. They also reflected the particular evolution of regional cooperation over financial regulation. By the time the Commission submitted the FSAP, the preferences of finance ministries were already in the process of changing. It is difficult to imagine French and German support for the financial program in 2000, for example, if the 1993 Investment Services Directive or ISD (Council Directive 93/22/EEC) had not helped to thwart London's dominance of continental equities trading. Provisions and ambiguities in that law protected exchanges against competition, giving the Frankfurt and Paris bourses time to re-organize and modernize (Story and Walter 1997: 21–2, 266–9; Steil 1998: 40–3).[18] This legacy of previous legislation contributed to a sense in France and Germany that domestic banks could prosper in a Europeanized regulatory system. It also helps to explain why the French continued to support the regionalization of regulation, even when core pieces of new legislation had a decidedly British flavor (Lalone 2005). Firm preferences were in flux before the Commission's campaign as well. In many cases, company preferences evolved as technological innovation combined with deficiencies in existing EU directives to create new problems. Internalization (i.e. in-house trading between clients of a single firm) and electronic trading networks, for example, led to new demands for an updated ISD.[19]

Fourth, European Commission officials tend publicly to depict the specific program of legislation contained in the FSAP as the outcome of intense consultation

[17] Author's interview with Delegation of the European Commission official in Washington, DC (May 4, 2004).

[18] Article 15.5 is the main source of ambiguity concerning stock exchange competition.

[19] 'Synthesis of Responses' to COM (2000) 729 at http://ec.europa.eu/internal_market/securities/isd/index_en.htm.

with vested parties following the June 1998 Cardiff Council (Commission 1998*a*: 2). Brussels civil servants did indeed consult broadly and embedded US-style openness in the new decision-making processes (see below). At the same time, however, the FSAP's legislative program was very much a product of history, pulling together legislative ideas that had been circulating for decades.[20] A previous relaunch of financial integration began with the Commission's April 1983 'Financial Integration', the main proposals of which made their way into Lord Cockfield's white book, 'Completing the Internal Market' of June 1985 (Commission 1983, 1985*a*). In the late 1990s, Commission officials did not simply dust off old proposals that had been sitting in drawers. In fact, many of the original ideas for integrating finance changed significantly over three decades, reflecting the constant state of change in financial sectors and the various constellations of interests among governments and firms.[21] The substantive focus of legislation, however, was remarkably consistent. More than a fourth of the proposed legislation comprised actual revisions of previous laws.

Finally, the general support for financial transformation was also due to the ability of Brussels officials to incorporate the views, preferences, and concerns of Europe's financial services companies. The civil servants were able to do so because of their central position in a policy network of Brussels-based European-level business lobbies (Posner 2005*b*; Jabko 2006). While some active pressure groups emerged in response to the FSAP, many others had been in operation for years, had symbiotic relationships with European Commission officials and often owed their existence to them. FESE (the Federation of European Securities Exchanges) is a good example. Commission officials had a hand in its origins, provided funding for various initiatives, and generally worked closely with its leadership for decades.[22] In putting together the FSAP, the officials trusted FESE to produce quality recommendations in sync with their own visions. Not only were many of its recommendations adopted, but at times they were indistinguishable from the Commission's, evidence of the close relationship developed over the years.[23]

The Passage of Major Legislation: The 2002 Accounting Standards Regulation

The broad support for financial transformation did not end with a long list of proposed legislation; it led to the passage of forty-one of the original forty-two by the 2005 agreed deadline as well as other measures not included in the

[20] Author's interview with European Commission official working for the Delegation of the European Commission, (May 5, 2004), Washington, DC.

[21] See, e.g., the discussions about a top-down single stock exchange in Commission (1980) and Schmidt (1977).

[22] Author's interview with FESE secretary-general in Brussels (June 9, 2004).

[23] Compare the recommendations on institutionalizing cooperation among securities regulators in FESE (2000), Commission (1998a), and Lamfalussy (2001).

initial package (Commission 2006*c*). The introduction of an EU law (Regulation [EC] No. 1606/2002 of the EP and the Council), mandating that publicly traded companies issue their consolidated accounts in accordance with new international financial reporting (accounting) standards,[24] illustrates well how years of incremental change built a foundation for rapid enactment of new legislation in the euro's wake. This example suggests that without decades of a slow-moving process, the FSAP's promoters would have achieved much less.

The 2002 accounting regulation is important because of the centrality of disclosure rules to capital markets. Accounting standards specify what information companies must reveal about their internal finances and operations and serve as a means of communication for determining value. Long-standing differences among accounting standards pose significant barriers to cross-border economic integration and contribute to continued fragmentation along national lines.

The law's passage represents a distinctive turn away from previous opposition by large member states to further accounting harmonization. The objective of two previous EU accounting laws (the Fourth [1978] and Seventh [1983] Company Law Directives) was minimal harmonization, and the resulting directives left a wide range of choices for national governments (Dewing and Russell 2004). In fact, by the end of the 1980s, the UK and Germany had all but abandoned the goal of further regional harmonization. Even though they had succeeded in imposing a core British principle[25] into the EU directives, UK negotiators found European legislative efforts too constraining (van Hulle 2004). In Germany resistance to increased disclosure came especially from smaller companies.

Part of the explanation for accounting standardization lies in the consensus built around financial reform and the opportunities it created for European Commission activism. From this perspective, the sense of urgency coalesced into agreement among Brussels officials, European finance ministers and the EP for convergence. Indeed, the City of London, the UK Treasury, and the French Trésor were all strong proponents. Everyone, moreover, seemed to agree that convergence of accounting standards would be central to a regional financial market. In June 2000, just two months after the approval of the FSAP, the European Commission announced its plan to propose mandatory standardization. In February 2001, it rolled out the official proposal, which gained approval from the EP and member state governments the following June.

While this momentum opened the door for a more activist role by European Commission officials, the passage of the new law can only be fully grasped by taking into account a series of small political compromises and bureaucratic steps,

[24] International accounting standards produced by the International Accounting Standards Board and its predecessor, the International Accounting Standards Committee, are now commonly referred to as International Financial Reporting Standards or IFRS. In the past, they were known as International Accounting Standards (IAS).

[25] The 'true and fair view' principle. See Dewing and Russell (2004).

beginning in the 1970s, that set the groundwork for future convergence (van Hulle 2004). The turning point was the adoption of US standards in the early 1990s by some high-profile European multinational firms (Ball 2004). This prompted European policymakers to revisit the issue. The firms, responding to market forces, chose US standards to reduce the cost of raising capital in US financial markets. From the perspective of EU decision-makers, however, the problem was more political than economic.

They chose international standards, rather than building directly on existing EU legislation, creating new European standards or adopting US standards (Commission 1995). The US option was eliminated because no one wanted to cede power to the US standard setter. One reason for the plausibility of adopting international standards was that EU company law already shared a common principle. Although unintended, the compromise that led to the adoption of the British principle in 1978 and 1983 facilitated convergence to international standards in 2002. Another reason was the already close ties between the European Commission and the international body that produced the international standards. This was a deliberate tactic on the part of Brussels civil servants, who recognized that these close interactions promised less painful adjustments in later harmonization efforts. For several years the two parties, through a symbiotic relationship, shared concepts in developing laws and standards (Knorr and Ebbers 2001).

Overcoming Procedural Obstacles: The Lamfalussy Process

Compared to decades of sporadic and piecemeal agreements, the comprehensive package of turn-of-the-millennium financial services legislation would alone represent a regulatory revolution. But the EU's financial transformation also includes metamorphic change in the procedures for producing new laws and rules, implementing them and supervising their application. The 2002 adoption of the Lamfalussy Process[26] is all the more striking because it marks a breakthrough in long-standing interinstitutional impasses (Pollack 2003*a*: 140–4; Bergström et al. 2004). Member governments (wary to delegate powers to the European Commission in a highly sensitive domain) and the EP (concerned about unequal oversight powers vis-à-vis governments) had resisted the extension of 'comitology' to the area of financial market regulation.

Again the widespread consensus is remarkable. Despite the significant interests at stake, nobody wanted to be seen as blocking procedural reforms that promised to enhance the prospects of the legislative program and to expedite the creation of a single financial market. German Finance Minister Hans Eichel, for example, accepted an ambiguous commitment from the European Commission not to override a simple majority (a promise that appears to have changed nothing) in order

[26] The Lamfalussy Process was first applied only to the securities sector. In 2004, it was extended to banking and insurance/occupational pension (Alford, forthcoming).

to clear the way for his government's approval of the Lamfalussy Process (Pollack 2003*a*: 143). French Finance Minister Laurent Fabius's support for overall financial transformation was so strong that he backed the final report of Alexandre Lamfalussy's Committee of Wise Men, even though it rejected his pet proposal for a centralized EU Securities and Exchange Commission (*The Economist* 2001). The EP, too, was affected by the momentum for sweeping financial change. In 2002, while it was still holding up procedural reform for reasons related to the interinstitutional division of powers, the legislature made several public statements making clear its support for the Lamfalussy report and a single financial market (Bergström, Almer, and Varone 2004: 14–15).

What accounts for this wave of support for overcoming the obstacles to procedural changes? How much of the explanation lies in shocks and how much in the accumulation of prior actions? At one level, the Lamfalussy Process can be interpreted as a direct and immediate spillover of the more general financial integration project. The Lamfalussy Committee explicitly used the argument that procedural reform was necessary to expedite the legislative program and ensure that regulatory structures did not undermine the potential benefits of an integrated financial market (Lamfalussy 2001: 7–8). It even borrowed some of the same framing that invokes both the euro and the US challenge: 'If [the EU] does not succeed, economic growth, employment and prosperity will be lower, and competitive advantage will be lost to those outside the EU. And the opportunity to complement and strengthen the role of the euro and to deepen European integration will be lost' (Lamfalussy 2001: 8).

At a deeper level, however, the Lamfalussy report appealed broadly and was perceived as a plausible reform package because its main provisions represented incremental changes. Indeed, the entire set of reforms is predicated on its practicality. Rather than opt for ideal regulatory structures like the risky proposal for a European SEC that would have had to be created from scratch, the committee built organically on what already existed. Thus, the attraction of the Lamfalussy Process is as much rooted in the small steps of the past as in the momentum sparked by the euro or the FSAP.

The creation of two new committees and the reliance on two levels of legislation and transparent and open consultation are the most important parts of the Lamfalussy reforms. All are adaptations of previous entities or ideas. The new Committee of European Securities Regulators or CESR, for example, is the formalization of the Forum of European Securities Commissions or FESCO, created five years before the adoption of Lamfalussy (*The Economist* 2001). The creation of a regulatory committee composed of high-level representatives of national finance ministries can also be traced to prior actions and ideas. The Commission's 1989 proposal for a directive on investment services recommended the creation of a European Securities Committee or ESC to monitor the implementation process (Bergström et al. 2004: 7–10). Although finance ministers rejected the

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proposal, the Commission kept the ESC idea alive throughout the 1990s. When the ministers finally agreed to an ESC, the EP, exercising its new powers under codecision in financial matters, blocked the extension of comitology to securities regulation until the interinstitutional deadlock could be resolved. Thus, the ESC met for the first time in 2001, but policymakers did not create the idea for the new committee *de novo*.

Likewise, the procedures that distinguish between framework laws and detailed rules and formalize open consultation were also not innovations of the Lamfalussy Committee. This approach to EU law-making evolved gradually from the introduction of comitology procedures (Sabel and Zeitlin 2006), made its way into the Commission's 1998 'Financial Services' document (Commission 1998*a*), and reflected the Prodi Commission's approach to EU governance in general (Almer and Rotkirch 2004), rather than a special solution to euro-era EU securities regulation. Indeed, the Lamfalussy Process synthesizes many generic forms that embody EU governance in the post-SEA era (Sabel and Zeitlin 2006).

Conclusion

This chapter concludes that the gradual accumulation of previous actions creates conditions for a seemingly exogenous event to quicken the pace of institutional change. The result in this case was profound financial transformation in Europe. The empirical evidence suggests that the euro and the US economic challenge were catalysts, largely responsible for the timing of change. They sparked a general consensus for broad reform, the passage of major pieces of legislation and the adoption of new legislative and supervisory procedures. The causes of the transformation, however, are more deeply rooted in a slow-moving cumulative process. Years of effort generated frames, political skills, proposals, legislation, and networks that enabled policy entrepreneurs to translate shocks into a consensus for financial regulatory change. Previous cooperation in Europe and years of close interaction between an international standard-setting body and EU officials, moreover, made later passage of an extraordinary accounting standard law possible. Finally, various components of the Lamfalussy Process are rooted in predecessors and innovations made years before, sometimes in different contexts. Without the gradual build-up of these conditions, the euro and US economic acceleration might have spurred some reform, but institutional and regulatory change would not likely have been as expansive nor would it have occurred as rapidly.

The empirical record, by revealing the importance of slow-moving background processes in shaping the effects of shocks, gives important support for HI insights about the constraining effects of the past. Yet a focus on the small acts produced by path-dependent processes—but, importantly, off the main policy path—also

advances our understanding of rapid instances of institutional change. These increments accumulate over time to create conditions that open possibilities for institutional innovation.

Finally, the EU financial transformation moves Europeans closer to one of their early goals: a single financial market (Commission 2005*a*). Ironically, the passage of a US law opened the world's eyes to the remarkable progress already achieved. By inadvertently increasing the cost of raising capital in New York, the 2002 Sarbanes-Oxley Act prompted global investors and companies to search for alternative financial centers (GAO 2006). With stable political systems, liquid and well-regulated capital markets, and a menu of assets that increasingly match the range of securities offered in the USA, the EU emerged as an obvious choice (Burgess and Postelnicu 2005; Authers and Gangahar 2006; Blackwell 2006; Wighton 2006). Predictions should always be proffered with caution. Yet it is now plausible to imagine that another external shock would consolidate the EU's role as an alternative to the American financial system, by driving petrol dollars and other financial flows and activity from the USA to Europe. Could such shocks include geopolitical strife and anti-Americanism? US deficits, a weakening dollar and global current account imbalances? Potential triggers are not in short supply, and time will tell how the foundations of the European project may translate them into further transformation at the EU level.

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